Re-Thinking Check-the-Box: Subpart F

By
Philip R. West*

Check-the-Box in the International Context: Early History of the Government's View

The first official published statement concerning check-the-box was Notice 95-14.[1] That notice, announcing that the IRS and the Treasury were considering the new regime and soliciting comments, contained the following observations regarding its international consequences:

> Because the complexities and resources devoted to classification of domestic unincorporated business organizations are mirrored in the foreign context, the Service and Treasury are considering simplifying the classification rules for foreign organizations in a manner consistent with the approach ... for domestic organizations
>
> [The IRS and the Treasury] must however take into account a number of special considerations that arise in the foreign area:
>
> A ... consideration in the foreign area is the possibility of inconsistent, or hybrid, entity classification; that is, classification as a taxable entity in one country but as a flow-through entity (*e.g.* a partnership) under the tax laws of another country. An elective approach could expand the potential that exists under the current classification regulations for hybrid structures. The Service and Treasury are considering whether it is appropriate to address inconsistent classification in any rules to be proposed and also are considering how the tax benefits or detriments that may result from inconsistent classification can be addressed through the tax treaty process.
>
> [Another] consideration in the foreign area is that a purely elective approach could have a substantive effect on entity classification by increasing taxpayers' flexibility to achieve their desired classification of certain foreign organizations. Under the present rules, taxpayers holding interests in foreign organizations are not always as able as those holding interests in domestic organizations to achieve their desired result. Because any change in the existing classification regulations is

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> intended generally to simplify the rules without resulting in a substantial change in the classification of unincorporated organizations, the Service and Treasury must consider whether an elective approach should be modified with respect to foreign organizations.

After the IRS and the Treasury had considered the comments received in response to Notice 95-14, they proposed regulations to adopt the check-the-box regime.[2] Due in part to the complexity that would result from any attempt to adopt, enforce and comply with two sets of entity classification rules, the above-quoted concerns generally did not result in different check-the-box rules for use in the international and domestic contexts (other than different default classification rules for foreign and domestic entities), and resulted in only the following cautionary statement in the proposed regulations' preamble:

> In light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, the Treasury Department and the IRS will continue to monitor carefully the uses of partnerships in the international context and will issue appropriate substantive guidance when partnerships are used to achieve results that are inconsistent with the policies and rules of particular Code provisions or of U.S. tax treaties.

The final regulations[3] contained a similar warning:

> As stated in the preamble to the proposed regulations, in light of the increased flexibility under an elective regime for the creation of organizations classified as partnerships, Treasury and the IRS will continue to monitor carefully the uses of partnerships in the international context and will take appropriate action when partnerships are used to achieve results that are inconsistent with the policies and rules of particular code provisions or U.S. tax treaties.

Subpart F: Basic Policies and Rules

Even for an audience for which an understanding of subpart F might be assumed, it is worth briefly restating subpart F's policies and rules where our purpose is to evaluate the operation of check-the-box in the subpart F context.

In general, U.S. corporations (and individuals) are taxed on their worldwide income (with a foreign tax credit). Foreign corporations (and individuals) not engaged in a U.S. trade or business are not taxed by the United States on their business profits. Therefore, a U.S. corporation can defer U.S. tax on its foreign business income by earning it through a foreign subsidiary.

Such a regime raises obvious issues. On a basic level, U.S. corporations with foreign operations can pay less tax than their competitors who operate solely in the United States, so long as the foreign operations are subject to lower taxes abroad than they would be subject to at home. This regime can act as an incentive to move operations/jobs abroad. And if all income could be sheltered from U.S. tax this way, all Americans would try to earn all their income through foreign wholly owned corporations.

U.S. tax law has long responded to these concerns. In 1934, the personal holding company rules, and, in 1937, the foreign personal holding company rules, were adopted to address some of them. In 1962, the controlled foreign corporation rules were added to subpart F of the Code.[4]

To the extent that a foreign subsidiary earns income that is passive and/or mobile (*e.g.*, interest, dividends, royalties, gain on the sale of stock, *etc.*, that are not earned as part of an active business), subpart F generally will require the parent to include that income in its income. To the extent the subsidiary's earnings are "active" (*e.g.*, income from business assets or the sale of such assets), subpart F does not generally require an inclusion. Also, subpart F does not generally require inclusion to the extent that certain passive income is received from a related party in the same country.

If a foreign subsidiary is organized in a low-tax jurisdiction to sell to customers in other higher-tax jurisdictions, the sales profit generally is subject to tax under subpart F. An exception exists if the foreign subsidiary manufactures the products it sells.

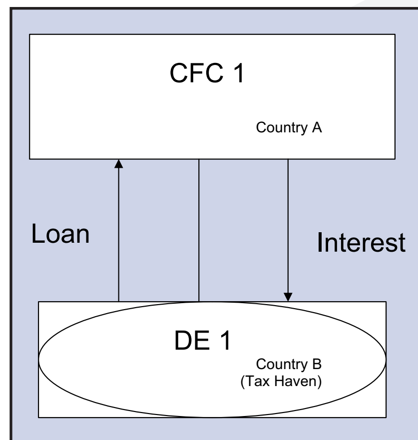
If a foreign jurisdiction imposes a sufficiently high effective tax on the foreign subsidiary's earnings, subpart F requires no inclusion. Moreover, if the amount of the foreign subsidiary's subpart F income falls below a *de minimis* threshold, no inclusion is required. Each foreign subsidiary's earnings or losses are separately considered when calculating inclusions, however. That is, in general, there is no foreign consolidation under subpart F.

Uses of Check-the-Box in Subpart F Planning

Use of Disregarded Loan for Earnings Stripping

Perhaps the most basic international use of check-the-box involves deflecting taxable income from a high-tax to a low-tax foreign jurisdiction. One technique for doing so is illustrated in Diagram 1.

Diagram 1



In this transaction, interest is paid by an operating CFC to its tax haven subsidiary where the subsidiary is disregarded for U.S. tax purposes. Because the subsidiary is disregarded, and the United States does not in general recognize inter-branch transactions for tax purposes, the loan and the interest payments are disregarded for U.S. tax purposes. Assuming that the operating CFC's income is subject to a positive foreign tax rate, the interest payment will generally be effective in reducing the tax burden on that entity's operations because the disregarded entity will bear little or no foreign tax on its interest income.

As indicated above, a prime objective of subpart F is to reduce or eliminate tax incentives to invest abroad. The rules clearly target tax planning to earn passive or mobile income such as interest subject to low rates of tax, but generally do not target income that is subject to a low foreign tax burden if that income is active. The example above might be argued to involve both tax planning to earn (1) passive or mobile income such as interest subject to low rates of tax, and (2) income that is subject to a low foreign tax burden but is active. As such, one question presented is whether the example is more of the type that should result in tax under subpart F, or more of the type that should not result in tax.

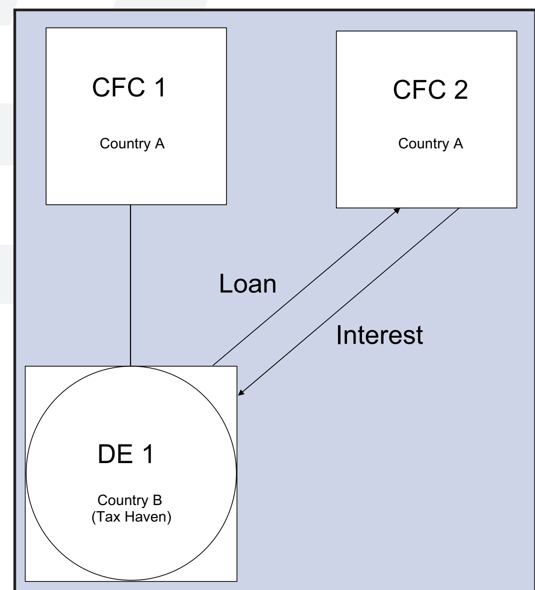
Some argue that there is no harm in reducing foreign tax and, in fact, the Tax Reform Act of 1986 encouraged taxpayers to do just that by restricting the foreign tax credit limitation. They further argue that if the foreign jurisdiction in which the CFC operates does not act to limit the effect that such earning stripping has on its own tax base, the United States should not act as that jurisdiction's surrogate by denying the benefits of that base erosion. Finally, they argue that whatever the merits of the policies behind subpart F when enacted, those policies are no longer appropriate because the United States is no longer the capital exporter it once was, and U.S. multinationals can no longer rely on their domestic markets to the extent they once could.

Others respond that focusing on the CFC's tax burden is only half the picture, and that it is the artificial diversion of income to a tax haven that is at the heart of the concerns animating subpart F. They further argue that the policies behind subpart F are more relevant today than ever. First, they point out that the economic theories underlying subpart F have not, after more than 40 years, been displaced by more compelling theories. Second, they point out that subpart F is fundamentally about fairness, and it is still today fundamentally unfair for a large business to pay less tax by earning interest in a tax haven and avoiding U.S. tax on that interest by making a tax election that has no nontax economic effect. Finally, they point to the fact that one reason subpart F was enacted was because of concerns about the stability of the dollar in light of the severe balance of payments deficit at the time.

Earnings Stripping Through Use of the "Same Country" Rule

Income can also be deflected to a tax haven from a jurisdiction in which an active CFC is subject to rates of tax comparable to U.S. rates through the use of a loan that is not disregarded. Diagram 2 illustrates such a technique.

Diagram 2



In this transaction, the loan is respected, and not disregarded. Although one party to the loan is a disregarded entity, that disregarded entity is owned not by the other party to the loan, as in the prior example, but by a different related entity. As such, for U.S. tax purposes, the loan is treated as being between two different persons and is respected. Because the two respected entities are in the same country, however, the parties can avail themselves of the exception to subpart F for interest earned by one CFC organized in the same country as the payor CFC.

Some argue that this transaction should not qualify for the "same country exception." They point out that the exception was designed for a situation in which the cash remains in the same country, but here the cash moves into a tax haven. They further argue that the statute is explicit that an analogous technique using a third country branch could not be used to avoid subpart F if the income were sales income, rather than interest, and so it would make no sense to allow this technique where the income is even more clearly passive—just the kind of income subpart F was concerned about. In fact, they point out, to allow the same country exception to apply here would create the anomalous situation shown in Diagram 3.

Diagram 3

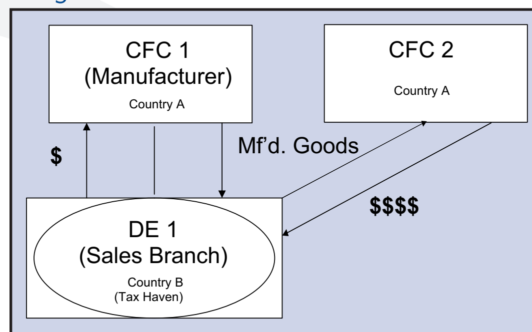
	Sales Income	Interest Income
Payment from one CFC to a tax haven CFC:	Subpart F income	Subpart F income
Payment from a CFC to a tax haven branch of another CFC:	Subpart F income	No subpart F income

Others argue that the statute is clear. There is a "branch rule" for sales income, but not for interest, so (1) it should be presumed that Congress intended no branch rule for interest, and (2) there is no authority for regulations that purport to state otherwise. They further argue, as above, that foreign tax reduction is an objective that is to be encouraged, not discouraged. Finally, they argue that to invalidate this planning would effectively eviscerate check-the-box for foreign transactions, and the harm that would be done by doing so outweighs any good that could come therefrom.

Compare Treatment of a Sales Branch

The "branch rule" referred to above is illustrated in Diagram 4. On the facts depicted, subpart F would apply to tax the income of DE1.

Diagram 4



Chain/Consolidation Issues

Effective for Reducing Subpart F Income. Diagrams 5 and 6 illustrate some potential irrationality in the subpart F rules which arises as a result of the fact that the rules apply entity by entity, and that there are only limited ways in which a CFC can take advantage of subsidiary losses. The first diagram illustrates that subpart F income can be reduced if a profitable CFC is a subsidiary of a loss CFC. To the extent that the profitable CFC pays dividends to the loss CFC, those dividends can be absorbed by the E&P deficit of the upper-tier entity.

Ineffective for Reducing Subpart F Income, Unless a Check-the-Box Election Is Made. Diagram 6 illustrates that, unless a check-the-box election is made, no similar benefit can be obtained where the loss CFC is positioned under the profitable CFC (assuming the inapplicability of a narrow exception for "chain deficits"). One may legitimately question whether the rules should provide such different consequences as a result of a fortuity relating to where the entities are situated in the group. In this case, it would appear that the check-the-box rules provide a self-help way to address this inequity.

Using Check-the-Box to Sell Assets Instead of Stock

Diagram 7 presents the fact pattern that was at issue in both the "check-and-sell" regulations[5] and the *Dover Corp.*[6] case. The policy question is whether a check-the-box election should be able to change a stock sale, which would generate subpart F income, into an asset sale, which generally would not. It has been argued that stock sales should not generate subpart F income in the first place and, therefore, this result is wholly unobjectionable. It has also been argued that, even if stock sales do generate subpart F income, there is no reason that a

check-the-box election should have any different consequence in this context than an actual liquidation.

Others argue that, to be treated as an asset sale under subpart F, the assets must be used in a trade or business of CFC 1, which is impossible in a check-the-box situation and unlikely even in an actual liquidation, if the sale takes place sufficiently close in time to the liquidation. They also argue that the reason subpart F applies to stock sales is because, as a matter of economic reality apart from tax consequences, stock is much more easily transferred than business assets and, therefore, gains from the sale of stock are inherently more mobile than gains from the sale of assets. As such, they are appropriately subject to U.S. tax irrespective of whether a tax election has changed, for tax purposes only, the character of what is being sold. This situation is illustrated in Diagram 7.

Other Planning Uses of Check-the-Box

Check-the-box is also used for a variety of other purposes in the subpart F context. For example, it can result in combined earnings and profits accounts between parents and subsidiaries, with the effect that the combined group qualifies, where at least one of the entities would not have previously qualified, for the *de minimis* exclusion from subpart F. Conversely, an election can save a corporation from having all of its income be treated as subpart F income under the "full inclusion" rule. Other planning opportunities also exist. In addition, combining entities can qualify the combined entity for the "high-tax" exception in circumstances in which the exception otherwise would not apply.

Is There a Problem? If So, How Should It Be Addressed?

Initially, it should be noted that, if there is a problem with any of these transactions, that problem might exist even in the absence of check-the-box. Check-the-box has "mainstreamed" the techniques, however, and, therefore, has mainstreamed the issue.[7] Therefore, it is fair to use evaluation of these techniques as an indirect way to evaluate the desirability of check-the-box in the subpart F context.

A review of these techniques can lead to any one of several conclusions:

I. The results are generally appropriate:
   A. The results are appropriate and, therefore, nothing should be done.
   B. The results are appropriate where the effect is to limit the reach of subpart F, and nothing should be done about check-the-box, but more should be done to limit the scope of the subpart F rules.

II. The results raise concerns:
   A. Where concern exists over specific uses of check-the-box, those specific uses should be addressed (*see, e.g.,* Code Sec. 894(c)), but the check-the-box rules should not be the vehicle for such changes.
   B. Where concern exists over classes of transactions, that class of transactions should be addressed. This could be through a change to the check-the box rules (*see, e.g.,* proposed "check-and-sell" rules), or a change outside the check-the-box rules.
   C. The foregoing examples illustrate that reforms are needed in the check-the-box rules:
      1. The disregarded entity concept should be changed:
         a. All entities should be recognized as entities for U.S. tax purposes, as U.S. partnerships are, even if they are not subject to tax, but only to the extent that they operate in the international context. This would present the challenge of determining when an entity "operates in the international context."
         b. All entities should be recognized as entities for U.S. tax purposes, even if they are not subject to tax, whether or not they operate in the international context.

Diagram 5

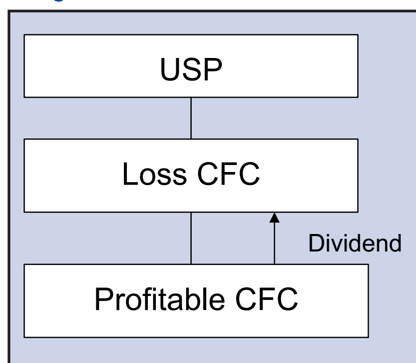


Diagram 6

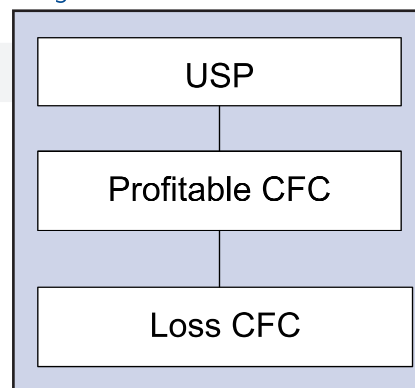
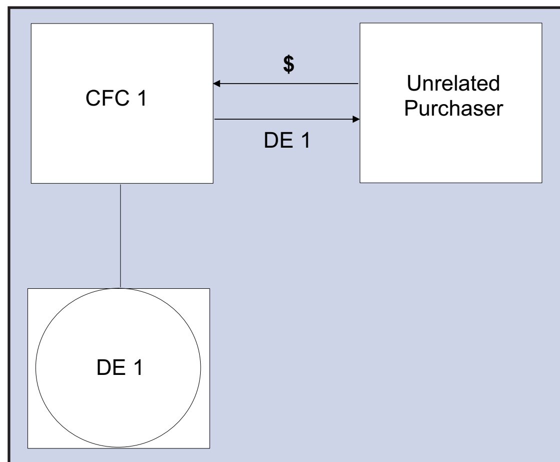


Diagram 7



2. Check-the-box should be changed more broadly:
   a. The check-the-box regulations should be withdrawn but only in the international context. *See* above regarding the challenge of determining "the international context." In addition, consideration obviously would have to be given to what the replacement regime would be. The options generally discussed, all of which have significant issues, include reverting to the four-factor test, using a modified four-factor test that views limited liability as a "super-factor," turning the default rules of the current regulations into immutable results and relying on the foreign characterization.
   b. The check-the-box regulations should be withdrawn for all purposes. *See* above regarding alternatives.

III. The check-the-box discussion is beside the point, and we should be focusing our efforts on fundamental international tax reform:
   A. We should adopt a territorial tax system.
   B. We should adopt a system of current taxation of all foreign income:
      1. We should tax that income at the same rates as domestic income.
      2. We should tax that income at reduced rates.

ENDNOTES

* The author acknowledges the helpful comments of his colleagues Stan Smilack and Keith Sieverding.

1 Notice 95-14, 1995-1 CB 297, 298 (Mar. 29, 1995).

2 PS 43-95, 1996-1 CB 865, 866 (May 13, 1996).

3 T.D. 8697, 1997-1 CB 215, 216 (Dec. 17, 1996).

4 By 1986, five sets of anti-deferral rules were on the books, and could apply simultaneously to the same taxpayer. Between 1986 and 1994, an additional set of rules, the passive foreign investment company (PFIC) rules, applied, for a total of six. In 1994, Code Sec. 956A, relating to "excess passive assets," was enacted and, therefore, seven sets of anti-deferral rules applied until those short-lived rules were repealed in 1997. Also in 1997, the overlap between the CFC and PFIC rules was generally eliminated, so that, in general, at that time, only five of the six existing sets of anti-deferral rules could apply to any one taxpayer with respect to any one foreign subsidiary. (It should be noted, however, that because qualification for the anti-deferral rules is generally tested at the foreign subsidiary level, elimination of the PFIC-CFC overlap did not mean that a U.S. taxpayer could not be subject to both regimes simultaneously, only that such a taxpayer generally is not subject to both regimes simultaneously with respect to any one foreign corporation.) Of those six remaining sets of rules, the American Jobs Creation Act of 2004 repealed two of them (the foreign personal holding company and foreign investment company rules) and repealed a third insofar as it applies to foreign corporations (the personal holding company rules). Therefore, as of today, only the CFC, PFIC and accumulated earnings tax (AET) rules still apply with respect to foreign corporations, and the effect even of those is mitigated because of the anti-overlap legislation referred to above, and because it is questionable whether the United States has jurisdiction to apply the AET to foreign corporations.

5 Proposed Reg. §301.7701-3(h), 64 FR 66591 (Nov. 29, 1999); withdrawn by Notice 2003-46, IRB 2003-28, 53. (This notice announced the intention of Treasury to revoke Proposed Reg. §301.7701-3(h), which was formally revoked on October 22, 2003, by publication of a notice of withdrawal in 68 FR 60305.)

6 *Dover Corp.*, 122 TC 324, Dec. 55,630 (2004).

7 To some, this observation supports the notion that check-the-box was a salutary development. To them, it democratized tax planning, so that hybrid entities were no longer solely the province of the well-advised, those willing to take tax risk and/or those who happened to be doing business in countries in which achieving hybrid status under the four-factor formula was relatively easier. To them, check-the-box planning was just the logical by-product of an initiative that was a simplification measure freeing taxpayers and the IRS from having to make difficult entity classification determinations. To others, check-the-box opened the door to a technique that was bad policy, exacerbated complexity by inviting widespread intricate planning, and was a potentially lethal blow to the corporate income tax, without any political debate over the desirability of reducing or repealing the corporate income tax.

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